Review of Recent Treaty Cases – *NatWest II*, *NEC* and *SA Andritz*

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1. *NATWEST II*

1.1. Background

NatWest II sounds like a Hollywood sequel to an earlier blockbuster. There was *NatWest I* – a decision of the US Court of Federal Claims issued in 1999.[1] Like some sequels, this new round in the *NatWest* litigation is likely to be of even greater significance than its prequel. This case may prove to be one of the most important international tax cases this year.

The background to this litigation goes back well before the 1999 decision. On one view, it goes back to 1981, when the US Treasury issued regulations (Treas. Reg. 1.882-5) introducing a formula to determine the amount of the interest deduction for foreign banks operating through branches in the United States. Foreign banks indicated that they regarded this formulary approach as incompatible with the various tax treaties concluded by the United States, and it was only a matter of time before a bank challenged those regulations. In *NatWest I*, Judge Turner of the US Court of Federal Claims held that the regulations were incompatible with the business profits article of the 1975 United Kingdom–United States double taxation treaty. The judge left it for a later hearing to determine what was the correct approach to computing the deductible interest of the branches. *NatWest II* was concerned with this issue; it was decided by a different judge of the Court of Federal Claims, Judge Firestone.

In a broader sense, the case goes back much further than this – to the 1930s when the League of Nations' Fiscal Committee carried out a study on the allocation of income of industrial and commercial enterprises operating in several countries.[2] The Fiscal Committee considered that, with respect to the permanent establishment of an industrial or commercial enterprise, the income should be allocated as if the permanent establishment were a separate enterprise operating at arm's length with regard to the rest of the enterprise of which it was a part. This separate enterprise approach has become part of the orthodoxy of international tax law and was reflected in Art. 7(2) of the 1975 UK–US treaty, which provided:

> ... where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

This is, of course, identical to Art. 7(2) of the OECD Model Tax Convention.

The essential issue in *NatWest II* was what the "distinct and separate enterprise" concept meant in practice.

1.2. The facts

The facts are very straightforward. National Westminster Bank (NatWest), which is resident in the United Kingdom, operated in the United States during the years 1981 to 1987 through six branches. These branches were subject to limited regulation under the Federal Reserve System. Unlike US subsidiaries of foreign banks, they were not subject to minimum regulatory capital guidelines or requirements; rather, they were subject to asset pledge and asset maintenance rules designed to ensure that a certain amount of funds would be available to pay creditors in the

1. *National Westminster Bank PLC v. United States*, decision of 7 July 1999, reported in 44 Fed.Cl. 120 (1999) and (1999) 1 *ITLR* 725. It should be pointed out that this author has had an involvement in this litigation as an expert witness on behalf of the US Treasury in connection with the UK taxation of branches of foreign banks. The views expressed in this article are entirely those of the author.
2. See Carroll, Mitchell B., *Two Decades of Progress under the League of Nations* (Geneva: League of Nations, 1939), at 27-32. The proposed draft convention on the allocation of income contained a specific provision relating to banking and financial enterprises.

event of a liquidation. Separately incorporated subsidiaries of foreign banks were regulated like any other US bank and were subject to minimum regulatory capital requirements. The balance sheet of NatWest designated a certain amount of "capital" to its US branches which resulted in a capital ratio (the ratio of capital to total assets) ranging from 0.76% to 1.75%.[3]

The issue between the parties was the amount of the interest deduction allowable in computing the profits of the US branches. For a bank (one of whose primary activities is the borrowing and lending on of money), the amount of the interest deduction is a crucial determinant of the taxable profits. This, in turn, depends on the amount of "free" working capital available to the branch – that is, capital allocated to the branch which it is able to put to use to generate profits and on which it has to pay no interest. The issue in this litigation was how far, and on what basis, the US government could adjust upwards the amount of free working capital allocated to the branches and, as a consequence, reduce the interest deduction for the branches.

The US Treasury Regulations had provided a formula for determining the amount of deductible interest, but in *NatWest I* that formula was held to be incompatible with the distinct and separate enterprise concept of the UK–US treaty. The issue in *NatWest II* was what, if any, adjustments the US government could make to the amount of free working capital.

The contradictory positions of the two parties were clearly drawn. The US Treasury argued that the distinct and separate enterprise concept required that each branch be treated as if it were a separately incorporated bank; the amount of "capital" appearing in the branch's books would then be adjusted to include such additional capital as the branch would need if it were a separately incorporated US bank. This was referred to as the "corporate yardstick" approach and would require a capital ratio of assets to liabilities of between 6% and 7%. In effect, this treated the distinct and separate enterprise concept as requiring the branches to be regarded as distinct and separate entities.

NatWest argued, however, that Art. 7 of the UK–US treaty did not allow for the "corporate yardstick" theory; instead, the capital should be determined in accordance with the properly maintained books of the branch. NatWest agreed that the books of the branch could be examined and adjusted where:
(1) an interest expense was deducted for advances that were not used in the ordinary course of the branch's banking business;
(2) an interest expense was deducted on amounts designated as capital in the branch's books or on amounts that were in fact used for capital purposes (such as funding capital infrastructure); and
(3) interest was paid on inter-branch borrowings on terms which were not at arm's length.

1.3. The decision and the reasons behind it

The decision in *NatWest II* was rendered on 14 November 2003. Judge Firestone accepted the arguments of NatWest. She stated:[4]

> The court agrees with NatWest. There is nothing in the language of Article 7 to suggest that the government is allowed to impose capital requirements on a branch that are the same as those imposed on separately-incorporated banks in order to give meaning to the phrase "distinct and separate". The phrase "distinct and separate" does not mean the branch should be treated as if it were "separately-incorporated", but instead "distinct and separate" means separate and distinct from the rest of the bank of which it is a part. Thus, Article 7 of the Treaty simply allows the taxing authorities to adjust the books and records of the branch to ensure that transactions between the branch and other portions of the foreign bank are properly identified and characterized for tax purposes. For example, if equity capital infusions are in fact made to the branch and are not properly identified as equity infusions, the taxing authority cannot allow interest payments on those amounts. Similarly, Article 7 allows the books and records of the branch to be adjusted to ensure that interest payments between the branch and other parts of the entity reflect an arm's length relationship. There is nothing in the plain words of the Treaty that allows the government to adjust the books and records of the branch to reflect "hypothetical" infusions of capital based upon banking and market requirements that do not apply to the branch.

In effect, the judge rejected the approach that the distinct and separate enterprise concept could ever mean a separate and distinct entity. The taxable profits of the branch should be determined from the properly maintained books and records of the branch, with only limited adjustments in accordance with Art. 7(2) to ensure that transactions have been properly identified and characterized and that any payments reflected an arm's length relationship.

The judge reached this conclusion for several reasons. First, she considered that the plain language of the treaty did not allow the government to tax the profits of a branch based upon regulatory capital requirements that apply to separately incorporated banks. Second, she considered that the US legislative history of Art. 7 of the UK–US treaty supported her decision.[5] She referred to the OECD statements made subsequent to the conclusion of the 1975 treaty in 1984,[6] in 2001[7] and in 2003.[8] She quoted extensively from these reports, but considered that they did not support the government's contentions. With regard to the 2001 report, she was clear that this could not affect the interpretation of the 1975 treaty: "First, there can be no

3. During the period under review, NatWest also had a separately incorporated subsidiary in the US which was subject to minimum regulatory capital requirements and had a capital ratio between 6.03% and 7.19%.
4. 58 Fed.Cl. 492 (2003), at 497-498, and (2003) 6 *ITLR* 292, at 302-303.
5. She referred, in particular, to the 1977 Treasury Department Technical Explanation of the US–UK Convention and the Senate Executive Report on the Convention.
6. OECD, *Report on the Taxation of Multinational Banking Enterprises* (1984).
7. OECD, *Discussion Draft on Attribution of Profits to Permanent Establishments* (2001).
8. OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments: Part II (Banks)* (2003).

doubt that the 2001 Discussion Draft could not and does not reflect the understandings of the Treaty partners in 1975. Subsequent statements made many years later do not reflect intent at the time of ratification."

None of the OECD reports to which the judge referred has the same status as the Commentaries to the OECD Model.[9] Nevertheless, the judge seemed to take the view that subsequent documents produced by the OECD cannot be used as an aid to the interpretation of a prior treaty.

In support of her decision, the judge also referred to a prior US Tax Court case, *NorthWest Life Assurance Company of Canada v. Commissioners of Internal Revenue* (107 T.C. 363 (1996)), which did not support the approach taken by the government. Finally, she considered that NatWest's position was consistent with the historic position of the United Kingdom. She referred to the Inland Revenue's Banking Manual as setting forth the United Kingdom's approach.[10]

The case is almost certain to be appealed. At present, however, it represents a clear expression of the views on the meaning of Art. 7(2) of the UK–US treaty (and of the identical provision in the OECD Model) and on the meaning of the distinct and separate enterprise concept. The judge made it clear that she rejected any idea that this is a reference to a separate and distinct entity: trying to operate Art. 7(2) by constructing an artificial hypothesis under which the branch should be regarded as a separately incorporated subsidiary would, in the judge's view, be clearly contrary to Art. 7(2).

1.4. Comments on the case

This case is clearly of major significance. At present, the OECD's work in the 2001 and 2003 reports (see 1.3.) develops the distinct and separate enterprise concept by using the working hypothesis of a distinct and separate entity. The OECD's approach has attractions. If the branch were treated as a separate subsidiary, one could apply the OECD *Transfer Pricing Guidelines*[11] and the established practice developed around the guidelines. The difficulty with the separate entity approach, however, is that it seeks to create a hypothetical construction which is different from the reality of a branch. The essence of a branch is that it is *not* separately incorporated – it is not a separate person from the remainder of the enterprise of which it is a part. Thus, all the assets of the enterprise stand behind the borrowings of a branch and, in reality, there are no transfers, borrowings or payments made between the branch and other parts of the enterprise.

If Judge Firestone's approach is correct, it signals two possible ways ahead for the OECD and its members. Under the first alternative, they accept that the distinct and separate enterprise concept in Art. 7(2) does not permit them to treat a permanent establishment as a separately incorporated entity. Under this approach, the *Transfer Pricing Guidelines* cannot be applied without some major adjustments, and the working hypothesis approach of the 2001 and 2003 reports would have to be abandoned. In effect, the OECD and its members would have to accept NatWest's approach under which the profits of a permanent establishment are determined primarily by the properly maintained books and records of the branch (if any), with limited adjustments where entries have been incorrectly shown in the books and records or non-arm's length payments have been recorded.

The alternative approach (and there are some hints in the 2001 and 2003 reports that this may be necessary) would be to redraft Art. 7(2) to make it clear that the distinct and separate enterprise concept means that a permanent establishment should be treated as a separately incorporated entity. In the author's view, this would need an express amendment to the wording of the OECD Model. The difficulty, of course, in these circumstances is that virtually all the existing tax treaties use the old wording: there would be two parallel principles operating until such time as the old treaties are amended.

The worst approach would be for the OECD to attempt to achieve this result simply by a change to the Commentary on Art. 7(2). If the OECD did this, it would simply be a matter of time before the effect of this change to the Commentary was tested in litigation. Aside from the uncertainty that this would create in the meantime, it seems likely – it would certainly follow from Judge Firestone's approach to subsequent OECD documentation – that the subsequent change to the Commentary would not be regarded as overriding the clear wording of specific treaties.

At heart, one of the difficulties with NatWest's approach is that it leaves the determination of the taxable profits of a branch largely to the books and records of the branch itself. The judgement refers to "properly maintained" books and records, but in the absence of clearly established international principles for maintaining branch records, it seems that this is far too nebulous a yardstick to resolve real disputes between tax administrations and branches or between different tax administrations. In many respects, therefore, the *NatWest II* case has not resolved the meaning of a concept that first surfaced in the 1930s.

2. *NEC*

2.1. Background

Cases on the non-discrimination article in tax treaties are relatively few and far between so that when two of them

9. Which are adopted by the OECD Council along with the text of the OECD Model.

10. It is on this aspect that the author of this article has been involved in this litigation. It is very doubtful that Judge Firestone correctly understood the UK's position. Under the Inland Revenue's Banking Manual, it has always been the practice that the amount of free working capital of a bank branch can be adjusted so that the limited role given to Art. 7(2) by Judge Firestone would not, in all probability, be accepted in the United Kingdom. If Judge Firestone's interpretation of Art. 7(2) is correct and is followed in the UK, this also raises serious doubts as to whether the new UK legislation on the attribution of profits to permanent establishments – specifically, Sec. 11AA(3) of the Income and Corporation Taxes Act 1988 – is compatible with the UK's existing double taxation treaties.

11. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, loose-leaf).

come along in close succession, it is quite an event to celebrate. The first is the *NEC* decision[12] of the English High Court; the decision of the French *Conseil d'État* in *SA Andritz* is discussed below (see 3.)

The background to the *NEC* decision lies in the UK imputation system, which operated between 1973 and 1999. Under that system, when a UK resident company paid a dividend, the company was required to account to the Inland Revenue for an amount of "advance corporation tax" (ACT), which was calculated as a percentage of the amount of the dividend. This ACT had two functions. First, it was a prepayment of the paying company's own corporation tax liability and could be credited against that "mainstream corporation tax". Of course, if the company had no taxable profits for that period but nevertheless paid a dividend, the ACT was an absolute tax cost. The second function was that the payment of ACT allowed the Inland Revenue to grant a dividend tax credit to the recipient shareholder; the tax credit was granted by domestic legislation only to UK resident individuals, but by tax treaty to residents of other states as well.

Where a UK resident subsidiary paid a dividend to its UK resident parent, the system operated so that the parent did not again have to pay ACT when it eventually paid a dividend on to its shareholders. There might be a timing disadvantage, however, if the subsidiary paid a dividend on which it had to account for ACT at the time of payment, and there was then a significant delay before the parent paid a dividend to its shareholders. Largely for that reason, UK domestic legislation – Sec. 247 of the Income and Corporation Taxes Act 1988 – provided for a "group income election". Where a UK resident subsidiary and its UK resident parent entered into such an election, no ACT was payable when the subsidiary paid a dividend to its parent, but the parent then had to pay ACT if it subsequently paid a dividend on to its shareholders.

Under UK domestic law, the group income election was originally available only where the parent and the subsidiary were both resident in the UK. This restriction to UK resident parents was successfully challenged before the European Court of Justice in the *Hoechst/Metallgesellschaft* cases.[13] The basis of these decisions was that the restriction conflicted with the freedom of establishment in the EC Treaty.

The *NEC* litigation concerned parent companies resident outside the European Union. These companies could not rely directly on the *Hoechst* case. Instead, they brought their claim (challenging the restriction on the availability of the group income election) primarily on the basis of the non-discrimination article in the relevant double taxation treaty. As a secondary argument, they sought to rely on the free movement of capital provision of the EC Treaty. A representative Japanese resident parent (NEC) and a US parent were chosen to test the issue.

In a judgement issued on 24 November 2003, Mr Justice Park[14] rejected the claims by the Japanese and US parents. He did so on grounds which are extremely interesting.

Essentially, there were two aspects to the principal argument based on the non-discrimination article: first, the meaning of the relevant paragraph in that article and, second, the incorporation of that article into UK domestic law. There was also the subsidiary argument based on Art. 56 of the EC Treaty. The judge dismissed that argument quite shortly.

2.2. First issue: meaning of the non-discrimination article

NEC, as a Japanese parent, sought to rely on Art. 25(3) of the 1969 UK–Japan tax treaty, which provides:

> Enterprises of a Contracting State [the United Kingdom], the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State [Japan] shall not be subjected in the first-mentioned Contracting State [the United Kingdom] to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State [the United Kingdom] are or may be subjected.

Art. 25(3) of the UK–Japan treaty is substantially identical to Art. 24(5) of the OECD Model.

The background facts in *NEC* are straightforward. The parent company in Japan had a UK subsidiary which paid it certain dividends. No group income election was made because it was considered that the UK legislation clearly prevented such an election. It was accepted that, had the group income election been available, the subsidiary and its parent would have made the election. In respect of some of the dividends, the ACT paid by the subsidiary was subsequently credited against its mainstream corporation tax liability. In respect of other dividends, however, there was insufficient mainstream liability so that ACT was a direct tax cost which the subsidiary would not have had to bear if it had had the opportunity of making a group income election.

In discussing the interpretation of the relevant paragraph of the non-discrimination article, Mr Justice Park began by observing that, if the paragraph had the effect that NEC contended, it was certainly an effect which was not intended. The UK–Japan treaty was concluded in 1969, four years before the imputation system. At the time of the 1975 UK–US treaty, the US Treasury Department Technical Explanation made no reference to the possibility of US parents making a group income election. Thus, neither the negotiators of the Japan treaty nor the negotiators of the US treaty intended the result that a group income election might be made in these circumstances.

Mr Justice Park identified three questions raised by the wording of Art. 25(3). First, and most crucially, what was the meaning of "other similar enterprises of ... [the United Kingdom]"? This was the key issue of the comparator with

12. *NEC Semi-Conductors Ltd, and others v. Commissioners of Inland Revenue*, decision of Mr Justice Park of 24 November 2003, [2003] *EWHC* 2813 (Ch) and (2003) 6 *ITLR* 416.

13. Cases C-397/98 and C-410/98, reported in [2001] *STC* 452 and (2001) 3 *ITLR* 385.

14. Who, as Andrew Park Q.C., was one of the leading members of the UK Revenue Bar.

which the treatment of the subsidiaries of the Japanese and US parents had to be compared. The second question was whether the fact that a group income election could not be made was "taxation or any other requirement connected therewith", and the third question was whether this taxation or connected requirement was "other or more burdensome". The key issue was the question of the comparator.

On this question, NEC contended that the comparison had to be with UK resident subsidiaries of parent companies resident in the UK: in that hypothesis, a group income election would clearly have been possible. Initially, the Inland Revenue contended that the comparator was with UK resident subsidiaries of parents resident in other states, not being either the UK or Japan. The group income election was, of course, not available to any subsidiaries of non-resident parents; thus, subsidiaries of Japanese companies were not disadvantaged when compared with subsidiaries of other non-resident parents. At the hearing, however, the Inland Revenue abandoned this approach (which in any event conflicts with decisions from other jurisdictions on the non-discrimination article[15]) and argued that there was no comparator, that is, there was no hypothetical situation of a company which was exactly identical to that of NEC. The reason for taking this approach was that a UK parent of a UK subsidiary would be in a different position from the Japanese company (NEC) or any other non-resident parent in that the UK resident parent would be liable to pay corporation tax and would itself have to pay ACT on any dividend it paid (assuming there was a group income election in place). In the case of a non-resident parent, however, that parent would not be liable to pay corporation tax, nor would it have to pay ACT on any distribution it made.

At first blush, the Inland Revenue's argument that there was no comparator seems unattractive. If one considers it further, however, it is a more sophisticated approach to the analysis of the situation. In truth, there was no real comparator with the situation of a Japanese resident parent and a UK resident subsidiary when one looks broadly at the issue of group income and the payment of ACT: a UK resident parent company receiving a dividend under a group income election would have to pay ACT if it subsequently paid on a dividend; no non-resident parent would have to do so.

Mr Justice Park thought that the most correct grammatical reading was to compare NEC with a UK resident subsidiary of another Japanese parent company. He rejected that view, however, in favour of the taxpayer's (NEC's) argument that the hypothetical parent company should be a resident of the UK. He did not think that the requirement of seeking a comparator required him to look at the tax treatment of the parent as respects dividends received and paid by the parent. In the context, he considered that a hypothetical UK resident subsidiary of a UK resident parent company was fairly comparable with the UK resident subsidiary of a Japanese parent.

Having decided that the comparator was with a UK resident parent (in which case a group income election would have been possible), the judge held briefly that the non-availability of the group income election was "taxation or any requirement connected therewith" and that it was more burdensome. In the judge's view, therefore, the non-availability of the group income election was in conflict with Art. 25(3) of the UK–Japanese treaty (and of the identically worded Art. 24(5) of the UK–US treaty).

2.3. Second issue: Sec. 788(3) and incorporation into domestic law

Having decided that the non-availability of the group income election conflicted with the non-discrimination article in the relevant treaties, Mr Justice Park went on to consider whether these non-discrimination provisions had been incorporated into UK domestic law. The background to this is as follows. Under the approach adopted by the United Kingdom, international agreements entered into by the UK government do not automatically become part of UK domestic law so as to give rights under domestic law. In order to give rise to such rights, the international agreement has to be incorporated into domestic law by an Act of Parliament or subsidiary legislation. In the case of double taxation treaties in relation to corporation tax, this is implemented by a mechanism under Sec. 788 of the Income and Corporation Taxes Act 1988. That section both provides a mechanism for incorporating the provisions of a tax treaty into domestic law and delineates the extent to which rights under domestic law are created by the treaty. The essential parts of Sec. 788 are subsections (1) and (3), which provide:

> (1) If Her Majesty by Order in Council declares that arrangements specified in the Order have been made with the government of any territory outside the United Kingdom with a view to affording relief from double taxation in relation to –
> (a) income tax,
> (b) corporation tax in respect of income or chargeable gains, and ...
>
> ...
>
> and that it is expedient that those arrangements should have effect, then those arrangements shall have effect in accordance with subsection (3) below.
>
> (3) Subject to the provisions of this Part, the arrangements shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide –
> (a) for relief from income tax, or from corporation tax in respect of income or chargeable gains; ....

The mechanism introduced by Sec. 788 is, therefore, for the text of the treaty to be included as a schedule to an Order in Council (a form of subordinate legislation). The arrangements specified in the Order in Council then have effect in accordance with Sec. 788(3).

The second issue in the *NEC* case was whether the non-discrimination article had effect in so far as it provided "for relief ... from corporation tax in respect of income or chargeable gains".

15. See, in particular, the *SA Andritz* case discussed in 3.

Mr Justice Park accepted that, because a tax treaty is brought into force in accordance with Sec. 788(3), this may mean that some of the provisions of the treaty will not be incorporated into domestic law – specifically, those provisions of the treaty which provide for matters other than those specified in Sec. 788(3). In his view, the non-discrimination article, in so far as it dealt with the group income election which removed the liability to pay ACT, provided for a matter that was not listed in Sec. 788(3). His reason for saying this was that ACT, though a form of corporation tax, was not a "corporation tax *in respect of income or chargeable gains*". Looking at the domestic law on ACT, this was a payment which a company had to make as a consequence of making a distribution (such as a dividend). ACT was payable irrespective of whether the company had income or chargeable gains. In the judge's view, ACT was payable in consequence of the payment of a dividend, but it had nothing to do with the company's taxable income or chargeable gains.

Mr Justice Park accepted that, if the provisions of the non-discrimination article had not been incorporated into UK domestic law, the actions of the Inland Revenue in operating the tax system in a way that conflicted with the treaty might be a breach of international law between the United Kingdom and the other contracting state. That did not, however, give the aggrieved taxpayer rights for which it could claim protection in the national courts of the UK. His final conclusion was, therefore, that, while the non-availability of the group income election was in conflict with the paragraph of the non-discrimination article, that article was not given effect as a matter of UK domestic law and no remedy was available to the taxpayer.

2.4. Alternative argument based on Art. 56 of the EC Treaty

NEC's secondary claim was dealt with very briefly by the trial judge. In the *Hoechst* litigation, the EU resident parent companies had relied on the freedom of establishment in Art. 43 of the EC Treaty. The Japanese and US parents could not rely on that article. They relied instead on Art. 56, the free movement of capital article, which provides:

> 1. Within the framework of the provisions set out in this Chapter all restrictions on the movement of capital between Member States *and between Member States and third countries* shall be prohibited (emphasis added).

It was the reference to restrictions on the movement of capital between Member States and third countries on which the Japanese and US parents sought to rely. In the view of the judge, however, they clearly fell foul of Art. 57, which states:

> The provisions of Article 56 shall be without prejudice to the application to third countries of any restrictions which exist on the 31st December 1993 ....

If the UK imputation system was a restriction on the free movement of capital, it clearly existed on 31 December 1993. The trial judge regarded this as an *acte claire* and did not consider it necessary to refer the issue to the European Court of Justice. In some respects, the Art. 56 argument is one of the most fascinating aspects of the case (but will clearly have to wait for another day to be resolved).

2.5. Comments on the case

In his judgement, Mr Justice Park made it absolutely clear that, if the non-discrimination article had the effect of extending the group income election to subsidiaries of Japanese or US parents, this was certainly something that was never intended by the treaty draftsmen. No doubt, there may be consequences which arise from the interpretation of a tax treaty many years after it was concluded that were never intended by the draftsmen. But perhaps this categorical finding that the consequence was never intended should have led the judge to pause before he reached the conclusion that he did.

No reference was made in the judgement to the overriding approach to treaty interpretation, which is set out in Art. 31 of the Vienna Convention on the Law of Treaties: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." The ordinary meaning of the words, in fact, pointed to an interpretation which the judge did not adopt.

What of the purpose of the non-discrimination provision in Art. 24(5) of the OECD Model? Surely, the purpose of that paragraph is to prevent a subsidiary from being subjected to discriminatory taxation merely on the grounds that it is foreign-owned. The paragraph is not supposed to have any relevance to the taxation of the parent; nor, as an extension of this logic, should it have any application to the taxation of payments made by the subsidiary to the non-resident parent. If a country imposes a withholding tax on dividends paid by a subsidiary to a non-resident parent, but not on dividends paid to a resident parent, no one would realistically suggest that this infringes the non-discrimination provision. If it were so, there would be a conflict between the dividend article in many tax treaties and the non-discrimination article. Why should the position be any different if, as opposed to a withholding tax, the subsidiary has to pay an amount of ACT when making a distribution to the parent which the subsidiary can elect not to pay if the parent is a resident company (which itself would have to pay ACT if it paid on a dividend following a group income election).

If one takes a purposive approach to the non-discrimination provision in the context of the imputation system, there is much to be said for the contrary conclusion to that reached by the Learned Judge.

One might also say the same of the Learned Judge's conclusion on Sec. 788. Technically, ACT is not corporation tax on income and chargeable gains. The purpose of Sec. 788, however, is to give effect to the international commitments undertaken by the UK government in the form of tax treaties. Mr Justice Park accepted that a failure to incorporate the non-discrimination provision into UK domestic law may have the result that the UK is in breach of its international obligations. That might have alerted the judge to the possibility that he should reach a contrary conclusion. It is a well-established principle of UK statutory interpretation that Parliament is intended to legislate in conformity with the UK's international obligations and not in conflict with them.[16] A narrow interpretation of Sec. 788(3)(a) leaves the UK in breach of its international obligations; a broad interpretation, under which ACT was regarded as a corporation tax on income and chargeable gains, would have avoided that result.

Overall, Mr Justice Park decided against the taxpayers, but both elements of the judgement are open to contrary views. It seems likely that the case will now proceed on appeal. It will be interesting to see whether any of these or similar arguments will persuade a higher court to reach a different conclusion.

3. *SA ANDRITZ*

3.1. Background

The compatibility of the French thin capitalization rules with EC law and with tax treaty provisions has been a contentious issue for a number of years. On 30 December 2003, the French *Conseil d'État* (Supreme Administrative Court of France) issued two judgements, one based on EC law and the other on the non-discrimination article in the relevant tax treaty, finding in both cases that the thin capitalization rules were incompatible. The case concerning EC law is *SARL Coréal Gestion*[17] and is not discussed further here. The case on the non-discrimination article is *SA Andritz*.[18]

Under Art. 212 of *Code général des impôts* or CGI (the tax code of France), the interest paid by a company subject to the corporation tax in France to an associated company is non-deductible to the extent the borrowing exceeds one and a half times the capital of the paying company. This thin capitalization restriction does not apply, however, if the recipient of the interest is the parent company of the payer company within the definition of CGI, Art. 145. Art. 145 does not require that the recipient company be resident in France, but simply that it be subject to the corporation tax in France at the normal rate. In practice, this means that the parent company must either have its seat in France or (if its seat is abroad) operate in France through a permanent establishment.

The background facts are very straightforward. The company SA Andritz[19] was a 99% subsidiary of an Austrian company, Maschinen Fabrik Andritz AG.[20] The French subsidiary paid interest to its Austrian parent and, in the years 1991 to 1993, following a tax enquiry, a fraction of the interest was disallowed by virtue of Art. 212. The French subsidiary was not able to take advantage of the regime for parent companies since its Austrian parent was not subject to the corporation tax in France at the normal rate. The French subsidiary appealed this decision to the *Conseil d'État* on the grounds that Art. 212, and specifically the restriction on the regime for parent companies, conflicted with a provision in the non-discrimination article in the 1959 France–Austria tax treaty (as amended by the protocol of 30 October 1970). Art. 26(3) of the treaty provided:[21]

> (3) Enterprises of one of the two States, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more persons domiciled in the other State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned state are or may be subjected.

In substance, this is identical to Art. 24(5) of the OECD Model.

3.2. Decision of the *Conseil d'État*

The *Conseil d'État* found in favour of the taxpayer company and held that the thin capitalization regime, with its exception for parent companies, was incompatible with Art. 26(3) and quashed the additional assessment on the French company. In reaching this conclusion, the *Conseil d'État* held that the comparison should made be with a French subsidiary of a French parent company, not with the French subsidiary of an Austrian company which had a permanent establishment in France.[22] If one made that comparison, the French subsidiary of the Austrian company was in exactly the same position as a French subsidiary of a company which satisfied the definition of "parent company" in CGI, Art. 145 (but was excluded from the regime for payments to a parent company).

The Finance Minister sought to rely on the provisions of the Commentary on Art. 9 of the OECD Model which were adopted subsequent to the conclusion of the treaty provisions at issue. The *Conseil d'État* was of the view that reference could not be made to subsequent provisions of the Commentary.

Before the *Conseil d'État*, the Finance Minister also sought to justify the readjustment to the taxable profits on the alternative basis of the general transfer pricing provision in CGI, Art. 57 and Art. 6(5) of the France–Austria treaty (which is similar to Art. 9(1) of the OECD Model). The *Conseil d'État* considered that neither Art. 57 nor the associated enterprise provisions in Art. 6(5) of the treaty allowed the Finance Minister to adjust the debt/equity ratio chosen by the foreign enterprise to finance its French subsidiary. The judgement of the *Conseil d'État* implies that the domestic transfer pricing provision and the equivalent of Art. 9 of the OECD Model do not permit the tax administration to adjust the debt/equity ratio chosen by

16. See *Bennion on Statutory Interpretation* (2nd ed., 1992), Sec. 270, at 564 et seq.
17. Case No. 249,049; conclusions by M. Goulard, the *Commissaire du Gouvernement*.
18. Case No. 233,894; conclusions by M. Bachelier, the *Commissaire du Gouvernement*.
19. Which was the successor to the company Andritz Sprout Bauer.
20. The argument based on EC law which was raised in the parallel case was not available since the years in issue pre-dated Austria's entry into the European Union.
21. This translation is from the Tax Analyst version of Art. 26(3). The original, contained in the 1970 protocol, was in the French and German official texts. This treaty has been superseded by a new treaty between France and Austria.
22. This is the same approach to the issue of the comparator as was taken by Mr Justice Park in the *NEC* case.

a company to fund its subsidiaries, but only to make an adjustment if the interest rate is not at arm's length.

5. CONCLUDING REMARKS

The *SA Andritz* case presents an interesting comparison with the *NEC* case. The *Conseil d'État* took a view similar to that of Mr Justice Park by holding that, when looking at the equivalent of Art. 24(5) of the OECD Model, the comparison must be made with a domestic subsidiary of a domestic parent company. In both cases, the courts concluded that the tax provision at issue was incompatible with the equivalent of Art. 24(5) of the OECD Model. One doubts whether either result would have been intended by the draftsmen of the respective treaties (in fact, Mr Justice Park thought that the answer to this question was "no"). Perhaps the time has come for the OECD to re-examine the real purpose and the drafting of the non-discrimination article in the OECD Model, which is commonly adopted in specific treaties.

It is also worth noting that both Judge Firestone in *NatWest II* and the *Conseil d'État* in *SA Andritz* were unwilling to apply subsequent statements by the OECD to the interpretation of a treaty concluded before the adoption of those statements. Both decisions suggest a judicial resistance to the ambulatory approach to the OECD Commentary.